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Shaping a New International Financial System: Contributions and Challenges

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1 Shaping a New International Financial System: Contributions and Challenges

KARL KAISER, JOHN J. KIRTON, AND JOSEPH P. DANIELS

Introduction: The Crisis and the Challenge

As the 1990s unfolded, citizens of the international community seemed destined to bid farewell to a turbulent twentieth century with a celebration of the end of the European cold war, the global spread of market democracies in its wake, and the buoyant prosperity and expanding freedoms they brought. Instead, the century closed with the global community engulfed in an unprecedentedly severe financial crisis that devastated many of the world's most rapidly growing economies, threatened the world's most mature and powerful countries, and called into question the mechanisms and very model of a globalised international economy and community.

The floating of the Thai baht on 2 July 1997 catalysed a contagious sequence of financial meltdowns. Over the subsequent year these devastated not only Thailand but also Indonesia, the world's fourth most populous country, and Organisation for Economic Co-operation and Development (OECD) member South Korea, imperiled such traditional bastions of stable growth as Malaysia, Hong Kong, and the People's Republic of China, and helped plunge the world's second largest economy, Japan, into deeper recession. On 17 August 1997, the crisis spread to Europe, when, three weeks after the latest infusion of financial support from the International Monetary Fund (IMF), the Group of Eight (G8)'s newest member Russia was forced to devalue its currency and default on its loans. Within a month, the global panic unleashed by the Russian default battered other G8 countries such as Canada, and threatened to paralyse the financial system of the world's most powerful and superbly performing economy, the United States. As 1998 moved into 1999 it was the America's which were afflicted, as Brazil faced a major run on its reserves and a sharp recession as a result. As Group of Seven (G7) and G8 leaders gathered in Cologne, Germany, in June 1999 for their 25th annual

Summit, a precarious calm prevailed, although strains in Argentina, and later South Korea, kept everyone in a state of nervous vigilance. The focus had shifted from the miracle to the meltdown of emerging economies in Asia and elsewhere, from the magic to the mania of the marketplace, from accolades to anxieties about globalisation, and from the vigour to the vulnerability of the leading industrial democracies and the international institutions they had constructed to govern global finance.

The G7 countries themselves escaped, if by the narrowest of margins, the most devastating effects of the crisis. But for the many countries who did not, the destruction it brought surpassed that of the great depression of the 1930s. Moreover, the speed with which it spread, the broad scope of the countries it swept up in its grasp, and the wide number of individuals within them whose life prospects were destroyed, gave it a unique character. The failure of the world's leading national authorities, international institutions, or market actors to foresee its outbreak, predict its course, or confidently contain its cumulative devastation reinforced the collective realisation that the international financial economy of the twenty-first century was very different in kind than that which had proceeded it. The crisis also made obvious that, in an interdependent world economy, more than mere openness to foreign capital and a free investment climate was necessary to guarantee a stable evolution, but that many conditions for the development of market economies in the developed world, which had been vital but generally overlooked, were of equal importance, such as the rule of law, regulations concerning the reliability of balance sheets, bankruptcy law, or rules forbidding corruption. It further bred a conviction that a fundamentally new architecture for its international governance had to be constructed if an open international financial system was to continue, and be controlled in ways that benefited all.

The challenge of creating that new architecture unleashed a series of intense debates over several fundamental and interrelated questions. What was the real cause of the Asian financial crisis and the contagion which brought it with such force to most regions of the world, and to many, but not all, of the countries within them? How best could the crisis be contained and who should take the lead, and bear the burden, in so doing? Was there a truly globalised rather than regionalised international economy, and to what degree and in what ways was it different than that which had proceeded it? Was a new architecture required to govern it, or merely a set of improvements and additions for the plumbing and the metres that regulated and monitored it? What principles and processes should guide the renovation effort, and what new procedures and mechanisms should be put in place? And who, within international institutions, national governments, private markets, civil society, and citizens of an ever more connected global community, should guide and govern the emerging market system?

These debates still rage in intellectual circles. But long before they will have come to command a consensus, indeed from the very early stages of the crisis, leaders of the international community equipped with only tentative answers and fragile confidence have been forced to confront the crisis and begin constructing an architecture that could cope with it, contain it, and vastly reduce the chances that it would return. In doing so they had to invent and institute a structure that would meet the needs of an increasingly globalised financial system and the aspirations of those throughout the world well beyond the financial community who were so profoundly affected by it. It was an effort that mobilised the energies and enthusiasm of many. But at the very centre of the effort were the deliberations, debates, directions, and decisions of the Group of Seven leading industrial democracies.

The Approach

This book explores the effort to contain the global financial crisis that erupted in 1997, to construct a new international financial system in its wake, and formalise the role in this process of the G7, its international institutional colleagues and competitors, and its member governments and financial communities. It embraces all of the fundamental questions unleashed by the crisis that still dominate analytical and policy debates. Yet its focus is on how well the crisis response and reconstruction effort, importantly shaped and guided by the G7, has proceeded as the new century begins.

This collection thus has three central purposes. First and foremost, it critically assesses efforts thus far to construct a new, strengthened international financial system to meet the needs of the global economy and community in the rapidly globalising world of the twenty-first century. Secondly, it challenges core elements of the epistemic consensus underlying this effort by subjecting the premises and principles of the emerging edifice to a hard analysis of their economic logic, market impact, and political feasibility. Thirdly, it offers suggestions about which directions to avoid, and which to pursue as the project to construct a strengthened international financial system moves into the decisive final stages required for its completion.

To meet these objectives, this collection assembles the analyses of leading experts from the scholarly and policy world. It embraces the talents of those within government, private sector finance, and the academic/research community. Its analysis is firmly grounded in the economics of international finance, and supplemented by the insights of political science and management studies. It includes experts from Europe, North America and Asia, and from all G7 member countries, as well as a view from the world outside. In many cases the insights of these authors have been shaped by their direct experience, in the past or present, in shaping and managing the international financial system. But in all cases they bring to bear outstanding academic and analytic credentials and the critical distance that flows from them.

No effort has been made to impose a common analytical or interpretive framework to guide these contributions. Each has been guided by the dual discipline of focussing on fundamental issues in the effort to shape a strengthened financial system, and to do so in a critical spirit guided by an independent analysis of underlying premises and processes. As a result, this collection reflects the diversity of the debate and points to new directions for advance, as each author addresses the core issues from a distinctive vantage point.

The Core Issues

Taken together, these analyses address the five core issues at the heart of the contemporary debate over shaping a strengthened international financial system. These deal with why the crisis came, how well the existing system responded, what more is needed now, which sector should bear the burden, and who should take the lead.

The first concerns the causes of the crisis and contagion and whether it has now been finally contained. How different was it from panics, manias, and depressions past? With the insights generated by the Mexican peso devaluation of December 20, 1994, the collapse of Barings Bank in the spring of 1995, and the focus of the G7 on international financial system reform at their 1995 Halifax Summit, could it have been anticipated and prevented? Was the crisis fundamentally the result of a collection of policy and institutional defects within particular countries, if at broadly similar stages of development, or was the crisis essentially driven by the dynamics of a newly globalised international system and the inadequacies of the principles, procedures, and institutions for its governance? Has enough now been done to contain and conclude the crisis, or is there merely a current respite until it resumes in its next stage?

The second core issue, flowing directly from the first, is how and how well the international community has coped with the challenges of crisis response and system strengthening thus far. Is the challenge one of calling for incremental reform, deeper reconstruction, or historic replacement with a very new system of principles practices, processes, and set of institutions? Whether the challenge be one of architecture or plumbing, is the project proceeding quickly enough? And is it unfolding in the correct direction, with an overall coherence and adequate allowance for experimentation, and subsequent mid-course correction?

The third core issue focusses on the particular critical defects of the old system and the best design for the new mechanisms to be added in response. What is the best weighting and mix of mechanisms for transparency, surveillance, precautionary lending, and international standstill or bankruptcy procedures? What are the best forms, procedures, and sequence of introduction and use for each? Is it necessary to move into broader domains, such as control of international financial and capital flows, greater exchange rate management, fixity, or even currency unification, and the rules for international liberalisation or foreign direct investment? How does one guard against consequences such as moral hazard?

The fourth issue is the relative responsibility and role - past and prospective, positive and normative - of international institutions, national governments, and private sector market players in the design and operation of the new system. How much and how should the principle of private sector burden sharing be instituted? What volume and form of additional public sector resources are required and where should they come from and be controlled? And what place do other civil society actors and their concerns have in the new architecture?

The fifth issue is the past, present, and prospective role of the G7, its governments, the financial community and citizens, in providing leadership and guidance in the construction and governance of the new system. Is it the United States alone or the G7 as a collective that has been, and remains the necessary centre of leadership and guidance? What has been the role, and what role should broader processes such as the new Group of 22 (G22) and now Group of Twenty (G20) and Financial Stability Forum (FSF) or the established IMF, World Bank, International Organisation of Securities Control Organisations (IOSCO) and other bodies play? And what is the best practical formula for involving those outside the existing centres of international financial governance, so that the necessary expertise, legitimacy, surveillance, and sanctions can be secured?

The Analyses

To address these core issues, it is necessary to explore in turn earlier efforts to shape and strengthen the international financial system, the actual crises of 1997-99, the specific issues at the heart of current effort to construct a new system, and the broader array of issues closely related to the process. Thus, Part I considers past successes and failures through the current crisis, from its origins in Asia, through its impact on emerging and G7 economies around the world, and the response of the G7 and its members at containment and control.

Chapter 2 begins with an analysis of efforts during the past quarter century to reform the international financial system, and the role of the G7 in this enterprise. In examining "The G7 Summit's Contribution: Past, Present, and Prospective", Nicholas Bayne identifies four earlier defining moments when the world, and the G7, confronted as a central challenge the task of altering in basic ways a financial system under severe stress. The first was the crisis over the global exchange rate regime that served as very *raison d'être* for the birth of the G7 summit as an economic institution - the breakdown of the Bretton Woods system of fixed exchange rates in 1971, the failure of the IMF and existing processes to construct a durable, widely accepted alternative, and the decision of the first Summit at Rambouillet, France in 1975 to institute a new system of managed floating. The second was the commercial bank debt crisis precipitated by Mexico's *de facto* default at the IMF meetings in Toronto in 1982, and the work of G7 summits from Versailles in 1982 to Paris in 1989 to arrive finally, in the form of the Brady Plan, at a solution. The third episode, debt relief for the world's poorest countries, began with the "Toronto terms" for relief at the 1998 Summit and continued through to the Cologne debt initiative of 1999. The final quest for the G7 has been its effort to cope with speculative financial crises, starting at Halifax in 1995 and continuing to the present day.

From this analysis flow five conclusions. The first is the unique opportunity the Summit offers G7 leaders to resolve issues that have defied solution at lower levels. The second is the need for advance preparation so leaders can use their time most effectively, while the third is the need to keep up the high level pressure until commitments are forged and implemented. The fourth is the need to move beyond the informal leadership of the G7 to integrate the new arrangements into formal organisations and give them legal force. The fifth is the indispensable need for the G7 to lead, but also through their own example, explanation, and sensitivity to the desires of outsiders, to secure a broader acceptance for their actions.

In Chapter 3, "The Asian Crisis and its Implications", Takashi Kiuchi looks, from a Japanese perspective, at the origins and causes of the Asian financial crisis, Japan's interpretation of and response to the crisis, and the lessons that can be applied to the task of rebuilding the international financial architecture. He locates the ultimate causes of the crisis in capital account rather than current account problems, liquidity rather than solvency problems, and the herding behaviour of investors, but notes also how politicians overriding their officials and regulators compounded the problem. Japan's response came initially in the form of a proposal for an Asian monetary fund that was abandoned in the face of US opposition, then with a "New Miyazawa Initiative" of US$30 billion worth of bilateral lending guarantees, proposals to reform the IMF, and new measures to make the yen an international currency. The major lessons of the crisis, Kiuchi concludes, are the need for decisive action at early stages, for enhancing the IMF's authority to deal with capital account problems, and closer regional policy co-ordination, beginning with macroeconomic policy and the development of an Asian bond market to replace short-term borrowing from distant bankers.

Kiuchi's analysis leads him to clear conclusions on many of the key issues in the debate over a new architecture. He rejects dollarisation as a solution for smaller Asian economies, but approves of short terms capital restrictions as a transitional measure, mandatory private sector burden sharing, and state bankruptcy codes. He calls for universal guidelines and processes for accounting, disclosure, bankruptcy, and financial supervision. But he calls for a staged approach to introduce these new measures, tightly tailored to the particular situation of each country, with proper macroeconomic policy reinforcing improved international regulation. Above all, he identifies the role of the G7 in moving toward a *de facto* target zone mechanism, and points to the benefits that further moves in this direction could bring.

In Chapter 4, "The G7, International Finance, and Developing Countries", Duncan Wood analyses the work of the G7 in operating and reforming the international financial system from the perspective of the developing countries, in particular, that of the ten large emerging market economies. The chapter first explores the record of the G7 during the decade from the late

1980s to the late 1990s, identifying how the developing countries have been affected by G7 initiatives in macroeconomic co-ordination, debt renegotiation and reduction, and international financial system reform. It then focusses on the main achievements of the 1999 Cologne Summit that affect developing countries, notably the Cologne debt initiative, broadening the membership of the Financial Stability Forum, and the increased importance accorded to the IMF Interim Committee, now renamed the International Financial and Monetary Committee. Wood also examines why and how the G7 might move toward a more meaningful dialogue with, and inclusion of, the major emerging economies, in the interest of improving the effectiveness and legitimacy of the international financial system being shaped to govern the global economy of the future.

Wood's conclusions are critical yet constructive. He judges that the G7 in the past has inadequately incorporated the views of developing countries as it has dealt with the issues that directly concern them. While the Cologne Summit brought some improvement, its advances remain inadequate to the need to involve the large emerging economies as they rise in relative power, and as their economic performance becomes ever more consequential to that of the G7 countries themselves. The clear need is to devise better processes for regular, formalised G7-emerging economy dialogue and consultation, based in part on the models that other international institutions have recently evolved.

In Chapter 5, "The Dynamics of G7 Leadership in Crisis Response and System Reconstruction", John J. Kirton explores the role of the G7, and of the lesser members within it, in responding to the crisis and constructing a new international financial architecture. He traces the diplomacy of and within the G7 through the three phases of the Asian crisis of 1997-98, the global crisis of 1998 and the reconstruction effort culminating at the Cologne Summit in June 1999. In doing so he highlights how it was the G7 collectively that ultimately prevailed, rather than the US alone, the IMF as a broad multilateral organisation locked in a neo-liberal model, or private sector markets and multinational corporations. Further affirming the leadership of the G7 collectively, rather than as a support group for American leadership, Kirton demonstrates how Canada and Britain, the least powerful members, were able to provide effective intellectual, policy, and structural leadership by advancing distinctive positions, combining with other members, and persisting to see their principles and positions prevail in the end.

Kirton's analysis challenges the traditional theories of why and how effective G7 co-operation has been achieved. In contrast to theories based on the indispensable element of an American willingness and ability to lead, he shows how the G7 came together at the initiative of other members in the face of a reluctant America deterred and immobilised at first by Congressional opposition to authorising the US share of a quota increase for the IMF, and in September 1998 by panicking market players on the verge of freezing its domestic credit system. Nor of great relevance in inducing collective G7 action were common lessons from the distant past, a false new consensus about the impotence of governments in the face of powerful markets and private capital flows, transnational coalitions involving sub-governmental and societal actors, or traditional differences between G7 members. Rather, the autonomous power of international institutions was evident as Canada and Britain were able to use their prerogatives and legacy as G7 hosts, and the G7 norms of consensus decision making to take and sustain a leadership role. Most importantly, it was the particular character of the G7 as a modern international concert, in the face of a systemic crisis, that allowed the smaller members to lead the G7, and the G7 to lead the international community with success.

Part II moves from the crisis, its consequences, and its containment to the particular core issues that dominated the debate over the principles and procedures on which a new international financial system should be based.

In Chapter 6, "Transparentising the Global Money Business: Glasnost or Just Another Wild Card in Play?", George M. von Furstenberg explores the different meanings of the now highly fashionable concept of "transparency". Noting that greater transparency always involves a redistribution of power, he distinguishes between statistical transparency and political transparency, or glasnost, and highlights how both were evident in abundance in the decisions of financial system reform at the Cologne Summit.

Given the many forms of uncertainty that exist in economic analysis, and the capacity of both "offensive" and "defensive" players to benefit from more information, von Furstenberg calls for greater skepticism on the part of policymakers and commentators about the progress to be made by securing greater statistical transparency alone. Indeed, he notes, a denial of data had little to do with the outbreak of recent financial crises in developing economies, and he judges that the greater transparency currently envisaged by the G7 will do very little to reduce the risk of future financial crises. He does, however, judge political transparency to be important, if it is linked to a comprehensive program of reform, while highlighting how it is the rich players in the rich countries who are likely to benefit the most.

In Chapter 7, "Global Capital Flows: Maximising Benefits, Minimising Risks", Joseph P. Daniels examines policy responses of the G7 in light of the perceived benefits and problems of liberalised capital markets. He first explains the economic benefits of liberalised financial markets and high quality intermediaries. Next he considers the problems that pervade financial markets and the constraints that capital mobility places on macroeconomic policy. Additionally the role of foreign speculators in the East Asian crises is considered.

Given the preceding arguments, Daniels considers the proposals put forward in the G7 Finance Ministers' *Strengthening the International Financial Architecture: Report of the G7 Finance Ministers to the Köln Economic Summit*. He finds that many recommendations support the principle of minimal market interference and avoid creating additional risk or diminishing country credibility. Unfortunately, he also finds that the G7 has offered little to the likely candidates of future financial meltdowns, the larger developing nations at an intermediate stage of financial development. Hence, he concurs with the general view of Duncan Wood in Chapter 4. Daniels concludes by suggesting a set of responsibilities for the G7 in the reform process.

In Chapter 8, "The New Financial Architecture for the Global Economy", Norbert Walter takes up the debate over transparency, and over several other central issues, notably the new Financial Stability Forum, equity ratios for financial institutions, supervision, and the broader questions surrounding Russia and the international trade system. Declaring that little has been done to reform the system to cope with another financial crisis that is sure to come, he casts doubt of the adequacy of the G7's emphasis on surveillance and the responsibility of each country to maintain a sound economic policy. Useful advances such as the Financial Stability Forum and improved equity ratios for financial institutions still require further work on the important details. Additionally, calls for greater transparency and surveillance suffer from the fact that in a world of "Snow White and the Seven Dwarfs", the resulting systems will be based on American models that other G7 governments, such as Germany, will resist.

More important, in Walter's view, is the fact that two fundamental issues have yet to be satisfactorily addressed. The first is the need for a mechanism to allow bankruptcy to take place in the financial sector. The second is for G7 governments to stop the recapitalisation or excessive capitalisation of ailing financial institutions.

In Chapter 9, "The Role of the International Monetary Fund as Lender of Last Resort", Curzio Giannini examines how a lender of last resort can deal with financial instability at the national level and whether the concept of an international lender of last resort makes sense in today's globalised economy. At the national level, he notes, the monetary framework and hence the lender of last resort function has now become very different from those specified in the classic model, as independent central banks have arisen to practice "illuminated discretion" in pursuit of a stability-oriented monetary policy. At the international level, while the founders of the Bretton Woods system kept the lender of last resort function at the national level, the question is now what can be done as a lender of last resort in a global environment.

Gianninni's conclusion is that very little can be done, as any grand design to transfer the lender of last resort function to the international level should be regarded with suspicion. Indeed, the IMF is already moving in the other direction, by providing credibility so otherwise financially frozen countries can borrow for private capital markets, by lending into arrears, and by involving private creditors through informal means in the Korean rescue package. Ginannini thus approves of the creation of contingent credit lines, and further moves to make creditors more sensitive to the risks they take, through either improved worldwide regulation and supervision or debt moratoriums with negotiated restructuring. The new Financial Stability Forum, with its emphasis on the former, faces a daunting task. But its very creation and early emphasis suggest that the IMF should refine its role of a provider of credibility, support smoother workout procedures, and avoid thinking of itself as a world central bank.

Part III moves from the debate over core financial questions to the broader issues closely related to them and ones whose treatment could well affect the particular measures selected and the success of their use.

In Chapter 10, "Practising Exchange Rate Flexibility", Olivier Davanne and Pierre Jacquet examine the question, now at the centre of the debate, of the appropriate exchange rate regimes for emerging and developed economies, and of the best international mechanism for ensuring the needed stability in the face of ever-threatening volatility, misalignment, and sometimes brutal shifts from an unduly fixed to a free floating regime. They outline the current consensus regarding the dangers of fixed exchange rates for emerging economies, and the costs of the alternative, forcibly adopted by many in the wake of the 1997-99 financial crisis, of freely floating regimes. They then examine the advantages of a managed floating regime, and the role the G7 and IMF play might play in effectively managing it.

Through their detailed economic and institutional, theoretical and empirical analysis, Jacquet and Davanne make a powerful argument that the current consensus needs to be rethought. Both economic rationality and the record of past decades show that exchange rate flexibility is necessary, and that highly fixed exchange rate regimes should be relied upon only exceptionally. Yet there is a broader array of available options, within which stands out an "adjustable reference parity" regime. In managing such a regime, the G7 and IMF, working in tandem, can do much to strengthen monitoring and surveillance, and thus contribute substantially to exchange rate stability.

In Chapter 11, "Can Small Countries Keep Their Own Money and Floating Exchange Rates?", George M. von Furstenberg looks inward at a central issue of finance - that of exchange rates - and outward from the G7 at the smaller countries in the system. He asks in particular what choice of exchange rate regimes exist for small countries that have fully opened up to international capital markets and free trade in financial services when they are located in the vicinity of a large country or group of countries whose currency is in wide international use. With G7 Finance Ministers in the lead up to Cologne advising that such countries' should generally not defend fixed exchange rates with borrowed money, and with most countries save for China having lifted traditional capital controls, the options for such countries reduce to floating exchange rates, currency boards, and monetary unions.

Von Furstenberg concludes that the first two of these options, for small and medium-sized countries with low credibility currencies, brings major problems of currency substitution and incomplete hedging, to the point where policy makers are driven to look at monetary union as a safe haven. Monetary union can take the form of unilaterally adopting as legal tender the strong international currency of a nearby country, or the multilateral Euroland route of deep financial integration on the basis of equality. The trend is thus toward regional currency consolidation, the disappearance of many lesser currencies, and the separate exchange rates and national monetary policies that accompany them.

Finally, in Chapter 12, "From Globalisation to Regionalism: The Foreign Direct Investment Dimension of International Finance", Alan M. Rugman broadens the focus from the activities of short-term investors in financial capital to the long-term foreign direct investment of multinational corporations (MNCs). He traces the rise and role of MNCs, how they vary widely by sector in their degree of globalisation, and the political power they exert in the face of national governments and intergovernmental organisations. In doing so, he takes issue with those who emphasise the destabilising impact of volatile short-term financial flows in a world of globalised "casino capitalism".

Rather, Rugman argues, the process of international integration is driven by the stable, foreign direct investments of MNCs, which engage overwhelmingly in a regionalism based on the rich triad countries of the US, Europe, and Japan, rather than any comprehensive globalism. For both triad-based MNCs in their production and marketing, and for governments in their efforts to support and regulate the process by creating international trade and investment regimes, it is the home region rather than the wider world that is primary. The collapse of Asian economic growth in 1997 and the contagious worldwide economic slowdown and contagion of 1998-99 was a result in part of the failure of Asian-based firms and governments to develop, through the Asia Pacific Economic Cooperation Forum (APEC) or otherwise, as strong and successful a regional strategy and regime as those of their North American and European counterparts with the North American Free Trade Agreement (NAFTA) and the European Union (EU). Further, the crisis of 1997-99 has driven all to turn even more away from global strategy to the relative safety of their regional bastions.

Agreement on Fundamental Issues

Amidst the wealth of insight and analysis that these chapters contain, there are underlying agreements on many fundamental issues. Above all, the contributors critically assess and challenge many core elements of the emerging consensus in policy and outside intellectual circles about the new system currently being constructed. Avoiding any temptation to celebrate the accomplishments of the G7 guided effort thus far, they offer at best a cautious confidence that much of the crisis response and system construction effort is proceeding with competence and often in the correct direction. They see, however, that there is no ground for complacency or inaction.

In "Challenges and Contributions to the Conventional Wisdom", the final chapter of this text, Kaiser, Kirton, and Daniels summarise the views of the various contributors by issue area. On the five fundamental questions at the heart of the intellectual debate and policy effort, the contributors offer an array of views, but also a large measure of agreement on what was, is being, and should be done. Taken together, these make a substantial contribution to our understanding of the debate over the international financial system the world needs to cope with in the twenty-first century.